

Project Name	Korea-Economic Reconstruction Loan
Region	East Asia and Pacific
Sector	Financial Adjustment
Project ID	KRPE55992
Borrower	Republic of Korea
Implementing Agency	World Bank 1818 H Street N.W. Washington, D.C. 20433 Telephone: (202) 458-5454 Fax: (202) 522-1500
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## Background

### 1. Country and Sector Background

The Korean economy has demonstrated strong performance for more than three decades. Since the mid-1960's, the country's gross domestic product (GDP) has grown at an average of 8.2 percent annually. Between 1991 and 1995, the economy expanded at about 7.5 percent per annum, unemployment was kept at less than 2.5 percent, and the current account deficits were in the 1 to 2 percent of GDP range. Throughout this period the government budget was in surplus in all but two years and inflation remained in the single digit range. However, this favorable performance masked weaknesses. Although government intervention enabled Korea to grow rapidly over the last decades and become an advanced industrial economy, it also preserved a protected and inefficient financial sector as well as a highly leveraged and concentrated corporate sector. Beginning in the early 1990s, Korea's export performance also came under intense competition in the labor intensive sectors. Korea responded by relocating production to ASEAN countries and China and by investing heavily in technology-intensive sectors. Thus, in recent years, Korea has invested heavily in a narrow spectrum of "strategic" export industries, such as automobiles and electronics, making it vulnerable to demand and price changes in a few industries. In 1996, a severe cyclical downturn hit the electronics sector, and this, combined with the slowdown in other export lines, dealt a significant terms of trade blow to Korea's economy. As a result, the current account deficit more than doubled to 5 percent of GDP. With the eruption of the financial crisis in Thailand, attention focused on some of the underlying weaknesses of the East Asian economies, and in October 1997 Korea also became the victim of regional contagion. It lost market confidence and was no longer able to attract sufficient amounts of new credits and roll over its existing obligations. On November 19, 1997, the Government formally approached the International Monetary Fund for assistance.

### 2. Objectives

The loan provides balance of payments assistance to Korea in implementing a program of financial and real sector reforms. The financing of the loan and its reform program would help Korea overcome its immediate liquidity problems,

restore investor confidence and assist in the resolution of fundamental problems in the real and financial sector.

3. Description

The package supported by the loan consists of satisfactory macroeconomic management, remedial actions related to the suspension of merchant banks, recapitalization of impaired commercial banks, improvements in the operations of Korea Asset management Corporation and the creation of a consolidated independent supervisory agency. The program also lays out an agreed agenda for broader financial and real sector reforms in the coming months. The loan complements the stabilization program supported by the International Monetary Fund.

4. Financing

The loan is a single-tranche operation of US\$ 3 billion. It is a single currency loan in US dollars for 10 years, including 5 years' grace, at an interest rate of 6-month US dollar LIBOR (reset semiannually) plus 1 percent. The service charge is as follows: 2 percent of the principal amount of the loan, payable on effectiveness (to be financed out of the loan and amortized), 1 percent of the principal amount of the loan, payable one year after the Effective date, and 1/2 of 1 percent of the principal amount of the loan, payable two years after the Effective date.

5. Implementation

Korea has a strong track record in the implementation of its undertakings with the Bank. Implementation of the on-going portfolio of nine investment projects is consistently rated as either satisfactory or highly satisfactory. Although this is a single tranche operation, the dialogue with Korea on follow-up operations will provide the occasion to monitor progress on the implementation of this loan.

6. Sustainability

The past 30 years have built a fundamentally strong economy with enormous physical capital resources, human resources and technological capacity. If new reforms can reconstruct the basis for allocating capital and opening markets to new competition, the country has the potential to rebound quickly.

7. Lessons learned from past operations in the country/sector

Korea has a strong track record in the implementation of its undertakings with the Bank.

8. Poverty Category

N.A.

9. Environmental Aspects

N.A.

10. Program Objective Categories

Structural reform.

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Note: This is information on an evolving project. Certain activities and/or components may not be included in the final project.

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